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OFFICE OF INSPECTOR GENERAL
OFFICE OF AUDIT SERVICES
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SUITE 316
PHILADELPHIA, PENNSYLVANIA 19106-3499

February 15, 2002

Our Reference: Common Identification Number A-03-01-00010

Mr. Steve Simms, CPA
Director, Intermediary Operations
CareFirst of Maryland, Inc.
1946 Greenspring Drive
Timonium, Maryland 21093

Dear Mr. Simms:

Enclosed are two copies of the U.S. Department of Health and Human Services (HHS), Office of Inspector General (OIG), Office of Audit Services (OAS) final audit report entitled **"AUDIT OF ADMINISTRATIVE COSTS CLAIMED UNDER PART A OF THE HEALTH INSURANCE FOR THE AGED AND DISABLED PROGRAM BY CAREFIRST OF MARYLAND, INC. FOR THE PERIOD OCTOBER 1, 1995 THROUGH SEPTEMBER 30, 1999."** The audit was performed by the Certified Public Accounting firm of Carmichael, Brasher, Tuvell & Company under a contract with the OIG. The OIG exercised technical oversight and quality control of the examination. In our oversight, we found nothing to indicate that Carmichael, Brasher, Tuvell & Company's work was inappropriate or that the report cannot be relied upon. A copy of this report will be forwarded to the action official noted below for his review and any action deemed necessary.

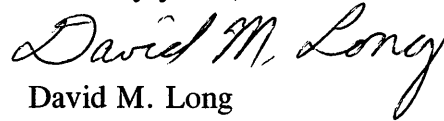
Final determination as to actions taken on all matters reported will be made by the HHS action official named below. We request that you respond to the HHS action official within 30 days from the date of this letter. Your response should present any comments or additional information that you believe may have a bearing on the final determination.

In accordance with the principles of the Freedom of Information Act (Public Law 104-231), OIG/OAS reports issued to the Department's grantees and contractors are made available to members of the press and general public to the extent information contained therein is not subject to the exemptions in the Act which the Department chooses to exercise. (See 45 CFR Part 5)

Page 2 - Mr. Steve Simms, CPA

To facilitate identification, please refer to Common Identification Number
A-03-01-00010 in all correspondence relating to this report.

Sincerely yours,

A handwritten signature in cursive script that reads "David M. Long". The signature is written in dark ink and is positioned above the printed name and title.

David M. Long
Regional Inspector General
for Audit Services

Enclosure

Direct Reply to HHS Action Official:

Steven McAdoo, Acting Regional Administrator
Centers for Medicare and Medicaid Services, Region III
Public Ledger Building - Suite 216
150 S. Independence Mall West
Philadelphia, PA 19106-3499

**REPORT OF EXAMINATION OF THE
ADMINISTRATIVE COSTS INCURRED
UNDER THE HEALTH INSURANCE FOR THE AGED AND DISABLED (MEDICARE)**

PART A & CWF

**CAREFIRST OF MARYLAND, INC.
BALTIMORE, MARYLAND**

**FOR THE PERIOD
OCTOBER 1, 1995 THROUGH SEPTEMBER 30, 1999
CIN: A-03-01-00010**

NOTICE

The designation of financial or management practices as questionable or a recommendation for the disallowance of costs incurred or claimed, as well as other conclusions and recommendations in this report, represent the findings and opinions of Carmichael, Brasher, Tuvell and Company, Certified Public Accountants, as concurred in by the DHHS OIG Office of Audit Services. Final determinations on these matters will be made by authorized DHHS operating division officials.

EXECUTIVE SUMMARY

Background

The Centers for Medicare and Medicaid (CMS)¹ administers the Medicare Program by contracting with private organizations to process and pay claims for services provided to eligible beneficiaries. CMS has contracted with CareFirst of Maryland, Inc., Baltimore, Maryland (CareFirst) to process Part A claims submitted by certain physicians and other medical suppliers in Baltimore, Maryland and CMS contracted with CareFirst to perform data match activities under a contract in which incremental costs only were paid. During the period October 1, 1995 through September 30, 1999, CareFirst claimed administrative costs of \$26,800,959 to process 7,809,953 Part A and claims. During the period October 1, 1995 through September 30, 1999, CareFirst claimed administrative costs of \$5,304,378 to perform data match activities under the Common Working File (CWF) contract.

Objectives

The objective of our audit was to determine whether (1) CareFirst had established effective systems of internal control, accounting and reporting for administrative costs and (2) the Final Administrative Cost Proposals (FACPs) presented fairly, in all material respects, the costs of program administration for the Part A program in accordance with Part 31 of the Federal Acquisition Regulations as interpreted and amended by Appendix B of CareFirst's agreement with CMS.

Results

We determined that CareFirst had generally established adequate systems for internal control, accounting and reporting for administrative costs. Further, the administrative costs for the period October 1, 1995 through September 30, 1999 were generally in accordance with Part 31 of the Federal Acquisition Regulations as interpreted and amended by Appendix B of CareFirst's agreement with CMS. However, we identified \$225,302 in costs claimed on the FACPs for which we recommend disallowance for the period October 1, 1995 through September 30, 1999 for the Medicare program and the Common Working File Host program.

- CareFirst made adjustments to CareFirst's cost reports and to the IER's to determine the amounts reported on the September FACPs for which adequate supporting documentation was not provided of \$82,280 for fiscal year 1997 for the Medicare contract.
- CareFirst allocated premiums to Medicare for health benefits in excess of the actual costs for the coverage plus administrative expenses of \$25,662 for fiscal year 1996 for the Medicare contract and \$2,000 for fiscal year 1996 for the CWF contract.

¹ On June 14, 2001, the Department of Health and Human Services announced that the Health Care Financing Administration (HCFA) would be known as the Centers for Medicare and Medicaid Services.

- CareFirst claimed \$11,606 in executive compensation during the fiscal period October 1, 1995 through September 30, 1999 which was in excess of the established limits as determined by Section 808 Public Law 105-85. Additionally, CareFirst claimed \$100,317 in executive compensation during the fiscal period October 1, 1995 through September 30, 1999 which was in excess of reasonable increases as determined by the Employment Cost Index or indirect allocation methodology.
- CareFirst understated Complementary Insurance Credits by \$2,196 for fiscal year 1999 for the Medicare contract.
- CareFirst calculated the return on investment costs using a rate of return greater than the actual return on investment calculated by CareFirst resulting in excess costs claimed of \$965 to the Medicare contract and \$276 to the CWF contract for fiscal year 1996.
- CareFirst calculated the average square feet of net usable space per direct employee in the Medicare claims processing facility to be 155 square feet and 136 square feet in fiscal years 1996 and 1998 respectively for the Medicare contract and 183 square feet for both fiscal years 1996 and 1997 for the CWF contract.

CareFirst submitted a response to our draft report which is located at the end of this final report. For brevity, we have not included the Appendix or Schedules which accompanied CareFirst's response. The Appendix and Schedules have been provided to CMS. We did consider the information contained in CareFirst's response and have made the applicable changes to the Findings and Recommendations contained within this report, and in other applicable sections of this report.

We evaluated CareFirst's system of significant internal accounting and administrative controls, and compliance with laws and regulations that could materially affect the FACPs. Based on our evaluation, except as indicated above, CareFirst's control procedures were adequate for the Department of Health and Human Service's purposes and that CareFirst complied with the provisions of Part 31 of the Federal Acquisition Regulations as interpreted and amended by Appendix B of CareFirst's agreement with CMS for the transactions tested. We have issued our report on compliance and the review of internal controls which appear on pages 4 and 6, respectively.

CareFirst of Maryland, Inc.
Baltimore, Maryland

October 1, 1995 through September 30, 1999

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INTRODUCTION

Background

The Health Insurance for the Aged and Disabled (Medicare) program was established by Title XVIII of the Social Security Act. Hospital Insurance (Part A) provides protection against the cost of inpatient hospital care, post-hospital extended care, and post-hospital home health care. Supplemental Medical Insurance (Part B) is a voluntary program that covers physician services, hospital outpatient services, home health care and certain other health services. Part A and Part B provide insurance benefits to (1) eligible persons 65 and over, (2) disabled persons under 65 who have been entitled to Social Security benefits for at least 24 consecutive months and (3) individuals under age 65 with chronic kidney disease who are currently insured by or entitled to Social Security benefits.

The Centers for Medicare and Medicaid (CMS) administers the Medicare Program by contracting with private organizations to process and pay claims for services provided to eligible beneficiaries. Contractors administering Part A of the program are known as Intermediaries and contractors administering Part B of the program are known as Carriers. The contracts between CMS and the Intermediaries and Carriers define the functions which are to be performed and that costs allowable under the contract will be determined in accordance with Part 31 of the Federal Acquisition Regulations as interpreted and amended by Appendix B of the contract.

Objectives

The objectives of our audit were to determine whether (1) CareFirst had established an effective system of internal control, accounting and reporting for administrative costs, incurred under the program and (2) the Final Administrative Cost Proposals (FACPs) presented fairly, in all material respects, the costs of program administration for Part A of the Medicare program in accordance with Part 31 of the Federal Acquisition Regulations (FAR) as interpreted and modified by Appendix B of CareFirst's contract with CMS.

Scope

Our audit was conducted in accordance with generally accepted government auditing standards. The audit objective was to determine whether administrative costs claimed by CareFirst on its FACPs to administer Part A of the Medicare program and the Common Working File Host program for the period from October 1, 1995 through September 30, 1999 were reasonable, allocable and allowable and whether the costs claimed for data match activities were incremental.

We examined the administrative costs claimed by CareFirst to the extent we considered necessary to determine if amounts claimed were in accordance with Part 31 of the Federal Acquisition Regulations as interpreted and modified by Appendix B of CareFirst's contract (Medicare Agreement and CWF Agreement) with CMS. Our audit included audit procedures designed to achieve our objective and included a review of accounting records and supporting documentation. Our audit excluded a review of pension costs claimed by CareFirst on the FACPs. Pension costs were reviewed by the Office of Inspector General, Office of Audit Services and as such, were excluded from the scope of our audit.

We reviewed the action taken by CareFirst on prior audit findings and the effectiveness of CareFirst's corrective actions in regard to the findings and recommendations. We reviewed and verified the accuracy of the cumulative "Interim Expenditure Reports" filed by CareFirst during the audit period. The tests performed were designed to determine if CareFirst prepared the reports based upon verifiable statistics which resulted in the accurate reporting of interim expenditures. We reviewed the methods and procedures utilized in the preparation of the September 1999 expenditure report to determine if the methods and procedures were adequately documented and would result in accurate reporting.

We reviewed CareFirst's compliance with complementary insurance policies and the amount of credit applied to CareFirst claimed administrative costs for the periods from October 1, 1995 through September 30, 1999. Our procedures were designed to determine if CareFirst was complying with complementary insurance policies and that credits due Medicare were properly included in the FACPs.

We reviewed the extent to which CareFirst had incurred significant costs for planning, developing or modifying the Medicare claims processing system.

Audit fieldwork was performed at the CareFirst office in Baltimore, Maryland from January 2001 through June 2001.

INDEPENDENT AUDITORS' REPORT ON
FINAL ADMINISTRATIVE COST PROPOSALS

We have audited the administrative costs incurred and reported on the Final Administrative Cost Proposals of CareFirst of Maryland, Inc., Baltimore, Maryland (CareFirst) for the period from October 1, 1995 through September 30, 1999. These Final Administrative Cost Proposals are the responsibility of CareFirst's management. Our responsibility is to express an opinion on the Final Administrative Cost Proposals based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America, Government Auditing Standards, 1994 Revision, and the Audit Guide for the Review of Administrative Costs Incurred by Medicare Intermediaries and Carriers Under Title XVIII of the Social Security Act, dated February 25, 1991, issued by the Office of Inspector General - Department of Health and Human Services. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Final Administrative Cost Proposals are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts in the Final Administrative Cost Proposals. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the Final Administrative Cost Proposals. We believe that our audit provides a reasonable basis for our opinion.

CareFirst's policy is to prepare and report its costs of administering Part A of the Medicare program and Common Working File Host program on the Final Administrative Cost Proposals in conformity with Part 31 of the Federal Acquisition Regulations as interpreted and modified by Appendix B of CareFirst's contract with CMS and CMS' reporting procedures. Accordingly, the accompanying Final Administrative Cost Proposals are not intended to be a complete presentation of CareFirst's assets, liabilities, revenue and expenses.

We did not audit and do not express an opinion on the pension costs contained in the Final Administrative Cost Proposals for the period October 1, 1995 through September 30, 1999.

In our opinion, except for the above pension costs and the adjustments as disclosed in the findings and recommendations section of this report, the accompanying Final Administrative Cost Proposals, as adjusted present fairly, in all material respects, the cost of administering Part A of the Medicare Program and Common Working File Host program in accordance with Part 31 of the Federal Acquisition Regulations as interpreted and modified by Appendix B of CareFirst's contract with CMS and CMS' reporting procedures.

This report is intended solely for the use described above and should not be used for any other purpose.

Carmichael, Brasher, Tuvell & Company

Carmichael, Brasher, Tuvell & Company
June 11, 2001

INDEPENDENT AUDITORS' REPORT
ON COMPLIANCE WITH LAWS AND REGULATIONS

We have performed an audit of the Final Administrative Cost Proposals (FACPs) of CareFirst of Maryland, Inc., Baltimore, Maryland (CareFirst) for the period October 1, 1995 through September 30, 1999 and have issued our report thereon, dated June 11, 2001.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and Government Auditing Standards, 1994 Revision, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the FACPs are free of material misstatement and whether CareFirst complied in all material respects with the provisions of Appendix B of the Medicare Agreement and the Common Working File Host Agreement.

Compliance with laws, regulations and agreement requirements applicable to CareFirst is the responsibility of CareFirst management. As part of obtaining reasonable assurance about whether the FACPs were free of material misstatement, and whether CareFirst complied in all material respects with the provisions of Appendix B of the Medicare Agreement and the Common Working File Host Agreement, we performed tests of compliance with certain provisions of laws, regulations and the agreement. However, our objective was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Material instances of noncompliance are failures to follow requirements or violations of prohibitions, contained in statutes, regulations or contracts, that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations are material to the Centers for Medicare and Medicaid (CMS) agreement and the FACPs.

The results of our tests of compliance disclosed potential immaterial instances of noncompliance (see Schedule of Adjustments) with CMS agreement provisions as disclosed in the Findings and Recommendations section of this report.

We considered the immaterial instances of noncompliance in forming our opinion on the FACPs and on CareFirst's compliance with CMS agreement provisions, and this report does not affect our report on the FACPs dated June 11, 2001 and the opinion rendered therein.

Except as described above, the results of our tests of compliance indicate that, with respect to the items tested, CareFirst complied, in all material respects, with the provisions referred to in the third paragraph of this report, and with respect to items not tested, nothing came to our attention that caused us to believe that CareFirst had not complied, in all material respects, with those provisions.

This report is intended solely for the use of management of CareFirst and the Department of Health and Human Services (DHHS). This restriction is not intended to limit the distribution of this report which, upon acceptance by the DHHS is a matter of public record.

Carmichael, Brasher, Jewell & Company

Atlanta, Georgia

June 11, 2001

INDEPENDENT AUDITORS' REPORT
ON INTERNAL CONTROL STRUCTURE

We have performed an audit of the Final Administrative Cost Proposals (FACPs) of CareFirst of Maryland, Inc., Baltimore, Maryland (CareFirst) for the period October 1, 1995 to September 30, 1999 and have issued our report thereon, dated June 11, 2001.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards for audits contained in the Government Auditing Standards, 1994 Revision, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the FACPs are free of material misstatement and whether CareFirst complied in all material respects with the provisions of Appendix B of the Medicare Agreement and the Common Working File Host Agreement.

In planning and performing our audit of CareFirst, we considered its internal control structure and administrative controls as they relate to the Medicare Agreement and the Common Working File Host Agreement in order to determine our auditing procedures for the purpose of expressing our opinion on the FACPs and whether CareFirst complied with Centers for Medicare and Medicaid (CMS) agreement provisions and not to provide assurance on the internal control structure. Our study and evaluation was more limited than would be necessary to express an opinion on CareFirst's system of internal control structure taken as a whole.

The management of CareFirst is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures.

The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of reports in accordance with CMS agreement provisions. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions, or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purposes of this report, we have classified the significant internal control structure policies and procedures and administrative controls in the following categories:

Accounting Controls

- Cash receipts and disbursements
- Payroll and fringe benefits
- Indirect costs

- Depreciation and use charges
- Claims processing charges

Administrative Controls

- Interim Expenditure Reports (IER)
- Final Administrative Cost Proposal (FACP) Reports
- Subcontract and EDP Contracting
- Cost of Investment
- Complementary Insurance Credit
- Budget Comparisons

For all of the control categories listed above, we obtained an understanding of the design of relevant policies and procedures and determined whether they have been placed in operation. We also assessed control risk for the control categories listed above.

Our consideration of the internal control structure and administrative controls would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the CMS agreement being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted certain matters involving the internal control structure and its operations that we considered to be immaterial weaknesses as defined above (refer to the Findings and Recommendations section of this report).

This report is intended solely for the use of management and the Department of Health and Human Services (DHHS). This restriction is not intended to limit the distribution of this report which, upon acceptance by the DHHS, Office of Inspector General, is a matter of public record.

Carmichael, Brashers, Jewell & Company

Atlanta, Georgia
June 11, 2001

**FINAL ADMINISTRATIVE COST PROPOSALS
(FACP'S)**

CAREFIRST OF MARYLAND, INC.
Final Administrative Cost Proposal
For the Period October 1, 1995 through September 30, 1996

FY96 - PART A

<u>OPERATION</u>	<u>ADMINISTRATIVE COSTS CLAIMED</u>
Bills Payment	\$ 2,799,513
Review and Hearings	230,785
Medicare Secondary Payer	654,800
Medical Review & Utilization Review	318,800
Provider Desk Review	634,866
Provider Field Audit	743,037
Provider Settlements	330,397
Provider Reimbursement	542,000
Productivity Investments	41,200
Benefit Integrity	142,100
Other	22,000
Credits	<u>(524,798)</u>
TOTAL ADMINISTRATIVE COSTS CLAIMED	<u>\$ 5,934,700</u>
Recommended Adjustments	
Executive Salaries	(19,381)
Fringe Benefit	(25,922)
Return on Investment	<u>(965)</u>
Total Adjustments	<u>(46,268)</u>
COSTS RECOMMENDED FOR ACCEPTANCE	<u>\$ 5,888,432</u>
Pension Costs for the Period	<u>\$ 152,526</u>

See Independent Auditors' Report.
Explanations of each adjustment are provided in the "Findings and Recommendations"
section of this report.

CAREFIRST OF MARYLAND, INC.
Final Administrative Cost Proposal
For the Period October 1, 1995 through September 30, 1996

FY96 - CWF

<u>OPERATION</u>	<u>ADMINISTRATIVE COSTS CLAIMED</u>
Bills/Claims Payment	\$ 0
Appeals/Reviews	0
Inquiries	0
Provider Education and Training	0
Medical Review & Utilitization Review	0
Medicare Secondary Payer	0
Participating Physician	0
Productivity Investments	0
Credits	0
Benefits Integrity	0
Other	<u>1,263,600</u>
TOTAL ADMINISTRATIVE COSTS CLAIMED	<u>\$ 1,263,600</u>
Recommended Adjustments	
Executive Salaries	(280)
Fringe Benefits	(2,000)
Return on Investment	<u>(276)</u>
Total Adjustments	<u>(2,556)</u>
COSTS RECOMMENDED FOR ACCEPTANCE	<u>\$ 1,261,044</u>
Pension Costs for the Period	<u>\$ 4,105</u>

See Independent Auditors' Report.
Explanations of each adjustment are provided in the "Findings and Recommendations"
section of this report.

CAREFIRST OF MARYLAND, INC.
Final Administrative Cost Proposal
For the Period October 1, 1996 through September 30, 1997

FY97 - PART A

<u>OPERATION</u>	<u>ADMINISTRATIVE COSTS CLAIMED</u>
Bills/Claims Payment	\$ 2,650,338
Appeals/Reviews	155,744
Medicare Secondary Payer	662,462
Medical Review & Utilization Review	414,974
Provider Desk Reviews	816,954
Provider Field Audits	647,912
Provider Settlement	359,816
Provider Reimbursement	506,996
Benefits Integrity	147,611
Productivity Investments	490,161
MIP Other	0
Credits/Other	<u>(404,157)</u>
TOTAL ADMINISTRATIVE COSTS CLAIMED	<u>\$ 6,448,811</u>
Recommended Adjustments	
Executive Salaries	(13,497)
Unsupported Adjustments	<u>(82,280)</u>
Total Adjustments	<u>(95,777)</u>
COSTS RECOMMENDED FOR ACCEPTANCE	<u>\$ 6,353,034</u>
Pension Costs for the Period	<u>\$ 28,095</u>

See Independent Auditors' Report.
Explanations of each adjustment are provided in the "Findings and Recommendations"
section of this report.

CAREFIRST OF MARYLAND, INC.
Final Administrative Cost Proposal
For the Period October 1, 1996 through September 30, 1997

FY97 - CWF

<u>OPERATION</u>	<u>ADMINISTRATIVE COSTS CLAIMED</u>
Bills/Claims Payment	\$ 0
Appeals/Reviews	0
Inquiries	0
Provider Education and Training	0
Provider Reimbursement	0
Productivity Investments	0
PM Special Projects	0
Medical Review	0
Medicare Secondary Payer	0
Benefits Integrity	0
Provider Education and Training	0
Provider Audit	0
MIP Special Projects	0
Other	<u>1,340,300</u>
TOTAL ADMINISTRATIVE COSTS CLAIMED	<u>\$ 1,340,300</u>
Recommended Adjustments	
Executive Salaries	<u>(20,616)</u>
Total Adjustments	<u>(20,616)</u>
COSTS RECOMMENDED FOR ACCEPTANCE	<u>\$ 1,319,684</u>
Pension Costs for the Period	<u>\$ 19,996</u>

See Independent Auditors' Report.
Explanations of each adjustment are provided in the "Findings and Recommendations"
section of this report.

CAREFIRST OF MARYLAND, INC.

Final Administrative Cost Proposal
For the Period October 1, 1997 through September 30, 1998

FY98 - PART A

<u>OPERATION</u>	<u>ADMINISTRATIVE COSTS CLAIMED</u>
Bills/Claims Payment	\$ 1,751,313
Appeals/Reviews	127,371
Inquiries	312,445
Provider Education and Training	149,129
Provider Reimbursement	705,928
Productivity Investments	1,286,530
Medical Review	463,218
Medicare Secondary Payer	561,628
Benefits Integrity	140,237
Provider Education and Training	56,467
Provider Audit	2,027,339
Credits	<u>(332,696)</u>
TOTAL ADMINISTRATIVE COSTS CLAIMED	<u>\$ 7,248,909</u>
Recommended Adjustments	
Executive Salaries	<u>(27,463)</u>
Total Adjustments	<u>\$ (27,463)</u>
COSTS RECOMMENDED FOR ACCEPTANCE	<u>\$ 7,221,446</u>
Pension Costs for the Period	<u>\$ 16,500</u>

See Independent Auditors' Report.

Explanations of each adjustment are provided in the "Findings and Recommendations"
section of this report.

CAREFIRST OF MARYLAND, INC.
Final Administrative Cost Proposal
For the Period October 1, 1997 through September 30, 1998

FY98 - CWF

<u>OPERATION</u>	<u>ADMINISTRATIVE COSTS CLAIMED</u>
Bills/Claims Payment	\$ 1,297,000
Appeals/Reviews	0
Inquiries	0
Provider Education and Training	0
Provider Reimbursement	0
Productivity Investments	38,800
PM Special Projects	0
Medical Review	0
Medicare Secondary Payer	0
Benefits Integrity	0
Provider Education and Training	0
Provider Audit	0
MIP Special Projects	0
Other	<u>0</u>
TOTAL ADMINISTRATIVE COSTS CLAIMED	<u>\$ 1,335,800</u>
Recommended Adjustments	
Executive Salaries	<u>(3,075)</u>
Total Adjustments	<u>\$ (3,075)</u>
COSTS RECOMMENDED FOR ACCEPTANCE	<u>\$ 1,332,725</u>
Pension Costs for the Period	<u>\$ 9,792</u>

See Independent Auditors' Report.
Explanations of each adjustment are provided in the "Findings and Recommendations"
section of this report.

CAREFIRST OF MARYLAND, INC.
Final Administrative Cost Proposal
For the Period October 1, 1998 through September 30, 1999

FY99 - PART A

<u>OPERATION</u>	<u>ADMINISTRATIVE COSTS CLAIMED</u>
Bills/Claims Payment	\$ 1,637,850
Appeals/Reviews	84,758
Inquiries	530,708
Provider Education and Training	271,646
Provider Reimbursement	826,242
Productivity Investments	93,849
Medical Review	670,066
Medicare Secondary Payer	536,052
Benefits Integrity	205,953
Provider Education and Training	0
Provider Audit	2,623,844
Credits	<u>(312,429)</u>
TOTAL ADMINISTRATIVE COSTS CLAIMED	\$ <u>7,168,539</u>
Recommended Adjustments	
Executive Salaries	(26,333)
Complementary Insurance Credits	<u>(2,196)</u>
Total Adjustments	<u>(28,529)</u>
COSTS RECOMMENDED FOR ACCEPTANCE	\$ <u>7,140,010</u>
Pension Costs for the Period	\$ <u>3,244</u>

See Independent Auditors' Report.
Explanations of each adjustment are provided in the "Findings and Recommendations"
section of this report.

CAREFIRST OF MARYLAND, INC.
Final Administrative Cost Proposal
For the Period October 1, 1998 through September 30, 1999

FY99 - CWF

<u>OPERATION</u>	<u>ADMINISTRATIVE COSTS CLAIMED</u>
Bills/Claims Payment	\$ 1,310,000
Appeals/Reviews	0
Inquiries	0
Provider Education and Training	0
Provider Reimbursement	0
Productivity Investments	54,678
PM Special Projects	0
Medical Review	0
Medicare Secondary Payer	0
Benefits Integrity	0
Provider Education and Training	0
Provider Audit	0
MIP Special Projects	0
Other	<u>0</u>
TOTAL ADMINISTRATIVE COSTS CLAIMED	<u>\$ 1,364,678</u>
Recommended Adjustments	
Executive Salaries	<u>(1,278)</u>
Total Adjustments	<u>\$ (1,278)</u>
COSTS RECOMMENDED FOR ACCEPTANCE	<u>\$ 1,363,400</u>
Pension Costs for the Period	<u>\$ 0</u>

See Independent Auditors' Report.
Explanations of each adjustment are provided in the "Findings and Recommendations"
section of this report.

FINDINGS AND RECOMMENDATIONS

CAREFIRST OF MARYLAND, INC.

Findings and Recommendations

For the Period October 1, 1995 through September 30, 1999

Unsupported Adjustments

In reconciling CareFirst's general ledger to the FACP for fiscal year 1997, CareFirst added costs of \$82,280 which consisted of several Arkansas invoices for EDP costs. We requested, but were not provided with the supporting documentation for these invoices. Per the Medicare Agreement, CareFirst "...shall maintain adequate accounting records covering the use of funds under this contract."

Recommendation

We recommend that CareFirst either provide the documentation to support the amounts recorded on the FACP in excess of amounts reported on CareFirst's General Ledger or IER or exclude \$82,280 from its FACP for fiscal year 1997 for the Medicare contract.

CareFirst's Response

CareFirst is trying to obtain copies of the Arkansas invoices for fiscal year 1997.

Auditor's Response

CareFirst provided information in response to our draft audit report which resulted in costs identified in this finding being reduced from \$1,407,203 to \$82,280. We now recommend that CareFirst either provide the documentation to support the amounts recorded on the FACP or exclude \$82,280 from its FACP for fiscal year 1997 for the Medicare contract.

Fringe Benefits

CareFirst self-insures its health benefits. CareFirst allocated premiums to Medicare for health benefits in excess of the actual costs for the coverage of \$25,922 for fiscal year 1996 for the Medicare contract and \$2,000 for fiscal year 1996 for the CWF contract.

Recommendation

We recommend that CareFirst exclude \$25,922 on the 1996 FACP for the Medicare contract and \$2,000 on the 1996 FACP for the CWF contract for gains recognized by CareFirst on fringe benefits provided to its employees.

CareFirst's Response

We agree with the associate health benefits in excess of actual cost finding for 1996 in the amount of \$27,922. CareFirst also determined that the FACPS were understated for associate health benefits in fiscal year 1997 of \$2,857, fiscal year 1998 of \$31,043, and fiscal year 1999 of \$12,026, totaling \$45,926.

CAREFIRST OF MARYLAND, INC.
Findings and Recommendations
For the Period October 1, 1995 through September 30, 1999

Auditor's Response

CareFirst provided information in response to our draft audit report which resulted in costs identified in this finding being reduced from \$558,355 to \$27,922. We now recommend that CareFirst exclude \$25,922 on the 1996 FACP for the Medicare contract and \$2,000 on the 1996 FACP for the CWF contract for gains recognized by CareFirst on fringe benefits provided to its employees. CareFirst may choose to amend the FACP's and claim the additional costs for health benefits in the other affected fiscal years.

Executive Compensation

The reasonableness of the salaries paid to executives is evaluated, in accordance with OMB guidelines, in terms of the increase in each executive's compensation in excess of the increase in employment cost index (ECI), annually. For all fiscal years under audit, several executive's compensation increased in excess of the ECI by \$19,381 for fiscal year 1996, \$13,497 for fiscal year 1997, \$27,463 for fiscal year 1998, \$26,333 for fiscal year 1999 for Medicare and for CWF, several executive's compensation increased in excess of the ECI by \$280 for fiscal year 1996 and \$13,363 for fiscal year 1997.

Also, CareFirst exceeded the limits established by Section 808 Public Law 105-85. The limits set by this law are \$250,000 for fiscal year 1997, \$340,650 for fiscal year 1998 and \$342,986 for fiscal year 1999. CareFirst did make adjustments for executive compensation prior to submitting the FACP's for the Medicare program. However, CareFirst did not make any adjustments to the Common Working File Host program for exceeded the limits established by Section 808 Public Law 105-85. We calculated that CareFirst should have adjusted the executive compensation by \$7,253 for fiscal year 1997, \$3,075 for fiscal year 1998 and \$1,278 for fiscal year 1999.

Recommendation

We recommend that CMI adjust its FACP's to exclude executive salaries of:

	In excess of P.L.105-85		In excess of ECI		Total Medicare Contract	Total CWF Contract
	Medicare Contract	CWF Contract	Medicare Contract	CWF Contract		
1996	0	0	19,381	280	19,381	280
1997	0	7,253	13,497	13,363	13,497	20,616
1998	0	3,075	27,463	0	27,463	3,075
1999	0	1,278	26,333	0	26,333	1,278
Subtotal	0	11,606	86,674	13,643	86,674	25,249
Total		11,606		100,317		

CAREFIRST OF MARYLAND, INC.

Findings and Recommendations

For the Period October 1, 1995 through September 30, 1999

CareFirst's Response

CareFirst disagrees with the audit finding related to the application of the ECI to Executive and Associate compensation. The average ECI percentage for the audit period 1996-1999 was 4.1%. During this period, the CareFirst annual budget process for overall total salary increases was limited to 4.3% with an additional .3% for administrative salary adjustments. This amount is reasonable compared to the ECI when the following are considered:

- CareFirst's Human Resource division utilizes numerous surveys and analytical tools to measure and determine Executive and Associate compensation. Comparisons include the relevant marketplace, industry, and specific job categories (Information Technology, Accounting, Claims & Service, etc.). CareFirst uses marketplace data relevant to the specific job. For example, non-exempt jobs are reviewed primarily against local marketplace whereas executive jobs take into account national and industry data. Market Reference Points (MRP's) are developed for each position. No position is compensated at a level of more than 120% of MRP. On average, CareFirst is at about 100% of MRP. Independent consultants are used to assist and review with hard to match positions and executive compensation.
- The ECI is an overall average and does not take into consideration specific industries (Health insurance, etc.), job categories, position level, or local job markets.
- A straight comparison of one year to the next does not take into consideration:
 - individual promotions
 - increased responsibility of individuals
 - compensation value added through experience and education
- During the audit period 1996-1999, CareFirst experienced many corporate changes. The overall size of the enterprise grew significantly through merger activity and contract growth resulting in increased responsibilities for its executives and management level associates. In 1996, CareFirst had \$1.96 billion in revenue and 1.4 million customers. By 1999, the company had grown to \$4.56 billion in revenue and 2.6 million customers. The ECI does not take these organizational changes into consideration.

With regards to the executive salary limits, CareFirst is compliant with the federal regulations related to executive compensation for Medicare Part A. CareFirst has consistently applied the FAR regulation addressing executive compensation. FAR Subpart 31.205-6 addresses limits on executive compensation and defines associates covered by the regulation. Amounts cited in the audit report for this category included amounts, which had been excluded from the allocable base in our cost allocation system. Certain executive bonuses and long term incentives were coded as nonchargeable to government programs in the cost allocation system.

CAREFIRST OF MARYLAND, INC.

Findings and Recommendations

For the Period October 1, 1995 through September 30, 1999

Auditor's Response

CareFirst provided additional information that documented that bonuses and long term incentives were in a natural account which was not allocated to Medicare. As such, the portion of the excess costs in these natural accounts have now been reduced for all fiscal years for the Medicare and CWF contract. We continue to recommend that CareFirst adjust its FACP's to exclude executive salaries in excess of P.L. 105-85 and ECI to the Medicare and CWF contract. (Refer to the chart above for amounts that should be adjusted for all fiscal years under audit.)

Complementary Insurance Credits

CareFirst provided a schedule of complementary insurance credits for fiscal year 1999 for the Medicare contract. The amount contained on the schedule did not agree to the amount reported on the FACP for fiscal year 1999. The amount reported on the FACP for fiscal year 1999 was \$312,429 and the amount contained on the schedule was \$314,625. CareFirst understated complementary insurance credits by \$2,196 for fiscal year 1999 for the Medicare contract.

Recommendation

We recommend that CareFirst adjust its FACP for complementary insurance credits by \$2,196 for fiscal year 1999 for the Medicare contract.

CareFirst's Response

CareFirst agrees with this finding.

Auditor's Response

We continue to recommend that CareFirst adjust its FACP for complementary insurance credits by \$2,196 for fiscal year 1999 for the Medicare contract.

Return on Investment

In fiscal year 1996, CareFirst calculated the return on investment using a rate of return of 6.44% when CareFirst provided documentation which indicated that the return on investment should have been calculated at a rate of 6.28% resulting in a \$965 overcharge to the Medicare contract and a \$276 overcharge to the CWF contract.

CAREFIRST OF MARYLAND, INC.
Findings and Recommendations
For the Period October 1, 1995 through September 30, 1999

Recommendation

We recommend CareFirst exclude excess ROI of \$965 and \$276 from its fiscal year 1996 FACP for the Medicare and CWF contracts, respectively.

CareFirst's Response

CareFirst agrees with this finding.

Auditor's Response

We continue to recommend that CareFirst exclude excess ROI of \$965 and \$276 from its fiscal year 1996 FACP for the Medicare and CWF contracts, respectively.

Net Usable Square Footage

Appendix B of the Medicare agreement allows CareFirst to allocate "an average of 135 square feet of net usable space" per direct employee in the Medicare claims processing facility or area. CareFirst allocated averages of 155 square feet in 1996 and 136 square feet in 1998 in the Part A contract. CareFirst did not provide justification or obtain approval for the amount in excess of 135 square feet. For the CWF contract, CareFirst averaged 183 square feet per direct employee in both 1996 and 1997.

Recommendation

CareFirst should provide justification for the claims processing facility allocated to Medicare in excess of the 135 square feet.

CareFirst's Response

The Medicare division has been located in the CareFirst facility with the lowest occupancy cost per square foot.

Auditor's Response

We continue to recommend that CareFirst provide justification for the claims processing facility allocated to Medicare in excess of the 135 square feet.

CAREFIRST OF MARYLAND, INC.
OTHER MATTERS

For the Period October 1, 1995 through September 30, 1999

Complementary Insurance Financial Policies

Our review of CareFirst's complementary insurance financial policies, as discussed in the "Scope of Audit" section of this report, disclosed that CareFirst's received approval for its complementary insurance claims processing operations, as required by program regulations. The complementary claims operation was approved by CMS in October 1997. It appears that CareFirst is calculating and crediting Medicare in accordance with the approved cost rate.

Plan's Interim Expenditure Reports

We reviewed CareFirst's method for preparing its Interim Expenditure Reports (IERs). No matters came to our attention during our review that would indicate that CareFirst's methods and procedures for the preparation of the Interim Expenditure Reports were not adequate.

Significant EDP Expenditures

No significant EDP costs were incurred during our audit period for planning, development or modification of the Medicare claims processing system for Part A of the Medicare program other than funds expended to correct problems associated with Y2K.

**AUDITEES' COMPLETE RESPONSE
TO THE DRAFT AUDIT REPORT**

November 19, 2001

Diana A. Crawford, CPA
Partner,
Carmichael, Brasher, Tuvell & Company
Dunwoody Exchange
1647 Mount Vernon Road
Atlanta, GA 30338

**Re: Draft Audit Report, CareFirst of Maryland, Inc. Administrative Costs for
The Period October 1, 1995 through September 30, 1999 Common
Identification Number (CIN) A-03-01-00010**

Dear Ms. Crawford:

Enclosed are CareFirst of Maryland, Inc.'s ("CareFirst") responses to the Draft Audit Report of Medicare Part A and Common Working File (CWF) Administrative Costs for Fiscal Years 1996 through 1999, dated September 19, 2001.

As explained further in the responses, CareFirst disagrees with the Findings and Recommendations of the Draft Report. CareFirst believes costs claimed in its Final Administrative Cost Proposals (FACPs) were for the benefit of Medicare Part A or Common Working File (CWF) programs, were equitably and consistently allocated, were reasonable in amount, and were allowable under applicable federal law/regulations and the October 1, 1987 contract.

Additionally, costs were reported consistent with the Centers for Medicare and Medicaid Services (CMS, formerly HCFA) guidelines and instruction for special projects, including the Y2K millennium initiative and Arkansas/FISS conversions. Accordingly, CareFirst respectfully requests you review our responses, reconciliations, supporting work papers or additional documentation and eliminate or revise the Findings and Recommendations.

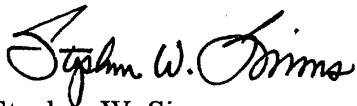
CareFirst requests the opportunity to discuss the additional documentation with your audit staff prior to a formal on-site exit conference.

*The Health Care Financing Administration (HCFA) was renamed Centers for Medicare & Medicaid Services (CMS).
We are exercising fiscal restraint by exhausting our stock of stationery.*

Diana A. Crawford
November 19, 2001
Page 2

If you have questions, please contact me at 410-561-4270 or Angela Miller, Manager External Audit Coordination at 410-998-4346.

Sincerely,



Stephan W. Simms
Director,
Intermediary Operations

Enclosures

Copy:	Leon J. Skros	OIG Audit Services, Philadelphia
	Mary Anne Heckwolf	CareFirst of Maryland, Inc.
	Angela Miller	CareFirst of Maryland, Inc.
	Charles Reip	CareFirst of Maryland, Inc.

CareFirst of Maryland, Inc.
Medicare Part A and CWF
Response to Draft Audit Report for Fiscal Years 1996 - 1999

November 19, 2001

GENERAL COMMENTS

Historically, audits of administrative costs conducted by or for the Centers for Medicare and Medicaid Services (CMS, formerly HCFA) have focused on the controls and procedures in place for the Intermediary's cost allocation system. This included verification of the cost centers allocation statistics. Audit steps were performed to ensure the statistics were current, supportable and the statistical methodology appropriately allocated costs benefiting lines of business, including Medicare. Cost center narratives were reviewed to ensure the cost centers allocating to Medicare provided benefit/value to Medicare. Audit steps were also taken to ensure costs included in the individual cost centers were appropriate and verifiable. Minimal, if any, focus was made on allocations between cost classifications or costs allocated between operations/activity codes.

CareFirst of Maryland, Inc. (CFMI) has invested significant time and effort to ensure its cost allocation system supports the steps indicated above. Cost center statistics are current and supportable by detail maintained in Cost Accounting. Cost Accounting also maintains narratives describing the purpose and function of cost centers to determine allocations to all lines of business including Medicare. CareFirst has maintained a dedicated Medicare Division with cost centers 100% dedicated and allocable to Medicare. The majority of costs allocated to Medicare originate from the dedicated division. In addition, the Medicare division has been located in the CareFirst facility with the lowest occupancy cost per square foot.

Recent changes in CMS reporting requirements (the introduction of Contractor Administrative-Budget and Financial Management System II, CAFM II) now require Intermediaries to report costs in 45-50 activity codes within various operations. This is a CMS designed and maintained national software. This often requires supporting Excel spreadsheets to be developed to "re-allocate" costs already determined by the cost allocation system to be valid Medicare costs into the 45-50 activity codes in CAFM II. The focus, therefore, shifts from "cost category" to "activity code". While total costs identified in the cost allocation system are accurate, valid Medicare costs, they must be manually redistributed to the activity codes. This can result in costs not retaining their original cost classification label or identification in the interest of reporting in the appropriate activity codes. In addition, prior to CAFM II, as well as in the CAFM II format, CMS reporting requirements include the allocation of "overhead" costs to various operations/activity codes. The majority of these adjustments are the result of allocating general & administrative, EDP, service, and finance costs from the overhead pool. As per above, this results in overhead costs that may not retain their original cost classification label or identification.

A significant amount of the costs questioned by this audit were a result of the audit's focus on the reconciliation of cost categories reported in the cost system compared to amounts reported in the FACPs. The audit report does not question the accuracy of the allocation statistics or the cost center narrative support. The attached schedules (A1 – D2) for the years audited, FY's 1996-1999, indicate CFMI's cost allocation system adequately supports total costs allocated and reported on the FACPs.

In addition to these reporting changes, numerous major initiatives and changes occurred during the audit period. These included but were not limited to:

- The unprecedented efforts of Y2K and Business Continuity and Contingency Planning (BCCP) in FY 1998, 1999, and 2000.
- Transition to Arkansas Blue Cross Blue Shield Data Center (July 1997)
- Conversion from Arkansas Part A Standard System (APASS) to Fiscal Intermediary Standard System (FISS) claims processing system in May 1998
- Backward/forward funding accounting requirements per CMS instructions
- Special handling of audit subcontract fees in 1999 per CMS instructions
- The doubling of CFMI's provider base when it inherited Aetna providers after they exited the Medicare program in April 1997
- Internal cost allocation system change from Financial Management Systems Cost Allocations (FMSCA) to the Oracle Financial Analyzer(OFA)

Many of the items above were funded as Productivity Investments (PI) requiring special handling outside the normal cost accounting system (time ticket transfers, manual journal entries, etc.). Project accounting challenges most accounting systems. Allocations to lines of business, cost centers, and natural accounts requires special effort. Adding a fourth level for 45-50 activity codes and a fifth level for PI projects creates additional difficulties and limits the level of detail at the cost classification level.

CMS provided a number of instructions that were atypical and contrary to normal accounting, including such things as incurring expense in one year and billing forward to another year (e.g. ADC conversion funded in FY 1998), or backward to a prior year when funding was appropriated (e.g. Y2K funded in FY 1998), the first \$200K audit subcontracts incurred in one year billed back to a prior year. These all necessitated multiple FACP supplements. Arkansas Data Center fees also created a large direct charge to a specific activity code (#11001) from a cost center assigned to the EDP overhead pool (CC771) -- requiring special handling. (See Appendix E for examples of CMS instructions for special accounting treatment).

Y2K was the largest project in CMS history (up to that time) and included special rules re: incremental overhead, incremental staff, and management time not 100% dedicated to the project.

All of these items created difficulty in the cost accounting system, shifted the focus away from cost classifications details to activity codes and fiscal years. Most health insurance

companies' cost allocation systems focus primarily on costs at the cost center level. This is also the focus of CareFirst's cost allocation system.

CareFirst's review of the audit findings indicates there is a duplication of findings as they relate to several different issues. Costs identified as Unsupported Adjustments for CWF in the amount of \$63,403 for 1996 also include \$40,359 for Unsupported EDP costs. This is one example of costs identified as "unsupported costs" also included in the administrative finding for cost classification differences between CFMI cost reports and FACP cost class totals. In addition, some of the executives included in the ECI finding were already included in the FAR executive compensation finding.

In summary, the majority of the findings were issued after the audit fieldwork was completed and were cost classification related. CareFirst is requesting the opportunity to meet with the auditors to review the additional attached documentation prior to a formal exit conference. It is CareFirst's intent to resolve these issues prior to the issuance of the final audit report.

RESPONSES TO AUDIT RECOMMENDATIONS

EDP Costs

This portion of CareFirst's response has been deleted as it pertained to matters included in the draft report which are no longer contained in the final report.

Unsupported Adjustments

Medicare A	\$ 1,150,422
CWF	256,781

CareFirst disagrees with this finding. The attached schedules (Appendix Schedules A1 – D2) for Medicare Part A and CWF include the reconciliation of costs from the CareFirst cost reports (FMSCA/OFA) to the amounts reported on the FACP's. The discrepancies between cost classification amounts are the result of the "reallocation" of costs to CMS activity codes/operations as indicated above in the general comments. The disallowed amounts in this finding are the result of comparing the CAFM cost class balances to the FACP cost class balances. This comparison does not take into consideration all of the administrative cost adjustments (year-end adjustments, accruals, etc.) as shown in the attached schedules and reallocation of costs for the respective years. This finding needs to be discussed and the work papers reviewed with the auditing team.

The nature or purpose of reconciling items have been summarized in the column headings on the attached schedules and are supported by other documentation or detailed work papers not included herein. These adjustments and transfers provide the audit trail for the FACP's.

Fringe Benefits

CWF

27,922

The Fringe Benefit finding can be classified into two components:

- 1) Associate health benefits in excess of actual cost
- 2) Cost classification

This portion of CareFirst's response has been deleted as it pertained to matters included in the draft report which are no longer contained in the final report. We agree with the associate health benefits in excess of actual cost finding for 1996 in the amount of \$ 27,922. However, after reviewing the audit work papers supporting the reason for the disallowance, CareFirst determined it undercharged Medicare in FY1997 (\$2,857), FY1998 (\$31,043), and FY1999 (\$12,026) totaling \$45,926. This finding needs to be discussed and the work papers reviewed with the auditing team.

Associate health benefits in excess of actual cost

CFMI associate health benefit costs are accounted for in all cost centers with staff as well as a nondivisional cost center. The nondivisional cost center captures all costs above or below budgeted amounts. This is a management control over total expenses. The nondivisional cost center does not allocate to the federal programs. Therefore, each year, the account balance in the nondivisional cost center/account for health benefits is reviewed to determine the adjustment required for the Medicare and the Federal Employee Programs. Amounts under budget result in a reduction to the charge on the federal contracts, amounts above budget require an increase to the charge to the federal contracts.

Cost classification

The attached schedules (attachments A1 – D2) for Medicare Part A and CWF include the reconciliation of costs from the CareFirst cost reports (FMSCA/OFA) to the amounts reported on the FACP's. The discrepancies between cost classification amounts are the result of the "reallocation" of costs to CMS activity codes/operations as indicated above in the general comments. The disallowed amounts in this finding are the result of comparing the CAFM cost class balances to the FACP cost class balances. This comparison does not take into

consideration all of the administrative cost adjustments (year-end adjustments, accruals, etc.) and reallocation of costs for the respective years.

Executive Compensation

Medicare A \$ 140,017
CWF 42,229

CareFirst disagrees with this finding in total for Medicare Part A. CareFirst agrees to an executive compensation adjustment in the amount of \$ 11,728 for CWF (\$7,253 for FY1997, \$3,075 for FY1998, and \$1,400 for FY1999). This finding needs to be discussed and the work papers reviewed with the auditing team.

FAR 31.205-6

CareFirst is compliant with the federal regulations related to executive compensation for Medicare A. CareFirst has consistently applied the FAR regulation addressing executive compensation. FAR Subpart 31.205-6 addresses limits on executive compensation and defines associates covered by the regulation. Amounts cited in the audit report for this category included amounts, which had been excluded from the allocable base in our cost allocation system. Certain executive bonuses and long term incentives were coded as nonchargeable to government programs in the cost allocation system. This confidential information is available for review by the auditors.

ECI

The draft report errs when it jumps to the conclusion that the increase in salaries was not reasonable because they were higher than the national average as calculated by the Department of Labor Statistics Employment Cost Index (ECI). In order to determine the reasonableness of the increases in salaries, the applicable Federal Acquisition Regulation must be reviewed for guidance. Section 31.205-6(b) encourages the review of outside data to determine the reasonableness of salaries.

It is the practice of CareFirst's Human Resource department to review its associate's compensation on a periodic basis. Industry standards, market demands, and individual qualifications are all taken into consideration when determining compensation. Various consultants are used including the Hay Group to review overall company compensation. Numerous surveys are used each year to provide support of salary market reference points. Total reliance on the ECI to determine the reasonableness of the increases is flawed for another reason. The ECI does not take into consideration data from "other firms of similar size" as required by section 31.205-6. Nor does it consider data from "other firms in the same industry" as required by section 31.205-6(b). CareFirst has considered this data and has applied it appropriately in determining the reasonableness of its salary increases.

Finally, the report erroneously classifies all of the associates identified as "executives". Indeed only 5 of the 10 identified are considered executives as defined by the FAR. Approximately \$81,000 of the executive compensation finding was related to associates not

considered executives under the FAR. Five of the executives included in the audit finding under the ECI, were already limited under the FAR finding.

Professional and Consulting Services

This portion of CareFirst's response has been deleted as it pertained to matters included in the draft report which are no longer contained in the final report.

Complementary Insurance Credits

Medicare A \$ 2,196

CareFirst agrees with this finding.

Return on Investment

Medicare A \$ 965
CWF 276

CareFirst agrees with this finding.

Net Usable Square Footage

Medicare A N/A
CWF N/A

CareFirst has provided additional information to support its average square footage per direct associate. In addition, as noted in the general comments section of this response, the Medicare division has been located in the CareFirst facility with the lowest occupancy cost per square foot. See additional comments in the Appendix, Schedule F.

Laura Hembree

From: <Bruce.Keaton@carefirst.com>
To: "Laura Hembree"
Sent: Monday, January 14, 2002 7:28 AM
Attach: Medicare audit.doc
Subject: Medicare audit
Updated

----- Forwarded by Bruce Keaton/IMD/BCBSMD on 01/14/2002
07:35 AM -----

Dana Reeves
01/11/2002 04:35 PM

To: Bruce Keaton/IMD/BCBSMD@CareFirst, Michelle Wright/IMD/BCBSMD
cc:

Subject: Medicare audit

This is the final response to the audit. Please call with any questions
X7845

(See attached file: Medicare audit.doc)
D

CAREFIRST BLUECROSS BLUESHIELD OF MARYLAND, INC.
MEDICARE
FACP AUDIT FY's 1996-1999 RESPONSE
"EXECUTIVE COMPENSATION FINDING"

Application of the ECI to Executive and Associate compensation

CareFirst disagrees with the audit finding related to the application of the ECI to Executive and Associate compensation. The average ECI percentage for the audit period 1996 –1999 was 4.1%. During this period, the CareFirst annual budget process for overall total salary increases was limited to 4.3% with an additional .3 % for administrative salary adjustments. This amount is certainly reasonable compared to the ECI when the following are considered:

- CareFirst's Human Resource division utilizes numerous surveys and analytical tools to measure and determine Executive and Associate compensation. Comparisons include the local relevant marketplace, industry, and specific job classes/categories (Information Technology, Accounting, Claims & Service, etc.). CareFirst uses marketplace data relevant to the specific job. For example, non-exempt jobs are reviewed primarily against the local marketplace whereas executive jobs take into account national and industry related data. Market Reference Points (MRP's) are developed for each position. No position is compensated at a level of more than 120% of MRP. On average, CareFirst is at about 100% of MRP.

- Independent consultants are used to assist and review with hard to match positions and executive compensation.
 - The ECI is an overall average and does not take into consideration specific industries (Health insurance, etc.), specific job classes/categories, position level, or local job markets.

- A straight comparison of one year to the next does not take into consideration:
 - individual promotions
 - increased responsibility of individuals
 - compensation value added through experience and education

- During the audit period 1996-1999 CareFirst experienced many corporate changes. The overall size of the enterprise grew significantly through merger activity and contract growth resulting in increased responsibilities for its executives and management level associates. For example, in 1996, CareFirst had \$1.96 billion in revenue and 1.4 million customers. By 1999, the company had grown to \$4.56 billion in revenue and 2.6 million customers. The ECI does not take these organizational changes into consideration.